

Real Estate  
Case Law Update  
Rosling King LLP



The impact of the Coronavirus pandemic on real estate finance has thrown the sector into uncharted and worrying waters. So, what are the likely ramifications? *Alexander Pelopidas, Partner at Rosling King LLP, explains:*

The government has been responding swiftly with a range of interventions including: business rate holidays, government-backed loans and rules to prohibit the eviction of commercial tenants impacted by the virus.

As the crisis continues it is highly likely that more will be needed. Promises of future initiatives, whilst details are ironed out by the government are of little help to businesses that are facing cashflow issues now. Finance parties need to take stock of their position as soon as possible, so that they can approach these challenging months ahead in an informed and decisive manner.

Lenders and borrowers need to rapidly assess their legal positions outlined in their loan documentation. It is key that an open dialogue is established between the parties as swiftly as possible, as this will improve the chances of a mutually beneficial outcome to these unprecedented events.

#### *What do the loan documents say and other legal considerations*

The first step is to revisit the loan documentation and consider a number of boilerplate clauses that may be triggered by current events:

##### *Loan to Value and Debt Service Cover*

The most immediate concern for both parties will be the issues surrounding cashflow and the ability to service interest payments. Valuations are likely to be hit (depending on the asset) - assuming they can be updated in this current climate of social distancing. Cure rights, in the form of pre-payment or grant of further security (assuming the borrower can afford to exercise them) could provide a temporary solution whilst the parties hope for the situation to improve. Far more likely, the parties will need to have a timely and open conversation regarding income forecasts, valuations and whether breathing-room can be provided to the borrower whilst the lender reserves its rights.

##### *Material Adverse Change (MAC)*

Most loan documents contain a clause covering a situation where there has been a material adverse change in, or effect on, the borrower's business, operations or assets (a MAC clause). Lenders tend to use MAC clauses as an additional breach to add into the mix alongside clearer events of default such as a financial covenant breach. Whether COVID-19 can be interpreted as causing a material adverse change on a borrower's business will ultimately need to be considered in terms of the specific impact it has on the business. Lenders should act with caution however, as the long-term impact of COVID-19 remains uncertain, albeit with the assumption that certain sectors (retail, leisure etc) will continue to suffer more from changes brought about by the pandemic than others.

### *Market Disruption*

Market disruption provisions seek to capture where a lender's cost of funds exceeds the relevant interbank lending benchmark rate, and the lender has the ability to calculate interest on the lender's cost of funding. This is relevant in the current climate with the loan market instability caused by Covid-19. However, given the difficulties in calculating cost of funds, it may be better to extend interest periods in the short-term to allow the borrower to benefit from increased liquidity.

### *Events of Default and Acceleration of the Loan*

The most obvious events of default that could be triggered are those that are insolvency related. In the near-term winding-up orders will not be made as it is understood that for public policy reasons the Companies Court will not be winding up any further companies by Order until 17 June 2020 at the earliest. These provisions can be drafted quite widely and do not require formal court filings to have been made or proceedings to have begun. Most events of default cover the legal definitions of insolvency, which include both cash-flow and balance sheet tests.

Even more broadly, agreements can include, as an event of default, the borrower making informal arrangements with creditors. This is something many businesses are likely to be undertaking at the moment in some shape or form. It is also common for there to be an event of default linked to the cessation of the borrower's business; although the specific drafting would need to be considered as to whether this applies because a borrower's business continuity plans may enable them to operate on some level.

Finally, it is worth considering that, even if the financial agreement being examined does not trip a borrower into default on its own merits, a default by that borrower under separate facility, may cause event of default under the cross-default provisions of the facility you are looking at.

### *Force Majeure*

Although not common, the finance documents may contain some form of force majeure clause which may suspend or terminate a party's obligations in circumstances beyond their control. The grounds for such rights to arise must be expressly listed in the provisions and a party cannot necessarily rely on the term "act of God" because it is a difficult thing to prove. Ideally there may be drafting referring to epidemics or pandemics but also anything to do with laws passed, or actions by, the government as it imposes the current lockdown across the UK.

### *The Doctrine of Frustration*

Generally, a contract may be discharged on the ground of frustration when something occurs after the formation of the contract which renders it physically or commercially impossible to fulfil, or transforms the obligation to perform into something radically different from that contemplated at the outset. Frustration is a hard rule to invoke and, in the context of a finance agreement, it will unlikely be available where the grounds relate to asset values and the impairment of a borrower's ability to service the loan. This is because the agreement is drafted to deal with such matters and the parties always bore them in mind from the start.

#### Other commercial and regulatory considerations

Of course, whilst understanding the legal position is key, finance parties will be acutely aware of external pressure from representative bodies and the government on them to be mindful of the unprecedented nature of the current crisis and how we are all in this together. Accordingly, there is a general growing expectation that everyone needs to temper their responses to Covid-19-related issues accordingly.

In this vein, the Prudential Regulation Authority (PRA) has issued guidance to banks and building societies regarding treatment of borrowers who breach covenants directly due to Covid-19. It urges lenders to consider their responses to such breaches and their consequences carefully. The PRA expects lenders to consider the need to treat those uncertainties which are of a general nature or are lender-specific but unrelated to the solvency or liquidity of the borrower differently. There is an expectancy that lenders would act in good faith and not impose new charges or restrictions on customers. Insurance lenders have also called for similar intervention from the PRA so that they can be flexible with borrowers and change loan terms, or give waivers, without forfeiting capital relief for their loans which they would otherwise lose by taking such actions.

#### Next Steps for finance parties

The key message at this testing time is that parties should be reviewing the finance documents that are in place, participating in an open dialogue to ensure business continuity and obtaining legal advice where necessary. State intervention has shown that the government is seeking a positive engagement from lenders and businesses alike so that everyone can best ride out what is likely be a prolonged global crisis.

These are unprecedented and extremely challenging times and any business that would like to talk through their concerns can contact [Alexander Pelopidas](#) or any member of the Rosling King team.

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